

## **THE STATUS OF HG-I POLICY COMPONENT**

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## **ABSTRACT**

This document is one of a series of periodic reports describing the status of the housing policy component of the 185-HG-I program for Hungary. The policy component includes eight areas on which progress is periodically monitored in order to measure the success of the HG program in Hungary.

As part of this report, a detailed discussion of the preliminary results of Hungary's major new housing policy development, the Housing Construction Allowance (HCA), is attached to this report as Annex A. The Annex is the second of an ongoing analysis of the HCA program, examining the effectiveness of the HCA as a counter cyclical housing program and as a cost effective subsidy to encourage the construction of housing in Hungary.

## **EXECUTIVE SUMMARY**

The Housing Guaranty Program Agreement signed in May 1994 between the Government of Hungary (GOH) and the Government of the United States describes a program consisting of three components, (1) policy, (2) program lending, and (3) technical assistance. This report comments on the status of the policy component of the Agreement.

The Agreement calls for the best efforts of the GOH to accomplish eight specific policy reforms in the area of housing finance over the term of the program (Annex B of the Agreement). The eight areas include adoption of a housing policy statement by the GOH, implementation of the deferred payment mortgage (DPM), the reform of GOH housing finance subsidies, actions to reduce credit risk, sounder lending practices, developing a credit enhancement structure, accessing long-term funds, and encouraging competition with the State Savings Bank (OTP). Each of these reforms is reviewed below, noting the accomplishments in each area and the remaining issues.

It should be noted that some of these policy actions were taken in advance of the signing of the Agreement, but as part of the discussions leading to the Agreement, which had started in October 1992.

As part of the discussion on reforming GOH housing finance subsidies, attached as Annex A is a detailed discussion of the preliminary results of Hungary's major new housing policy development, the Housing Construction Allowance. This paper is the second of an on-going analysis of the HCA program. The first analysis was completed in draft form in August 1995, and provides a more extensive discussion of the program. The focus of this paper is on predicting the future costs of the program and how the restrictions imposed in May 1995 will modify it over time.

## THE STATUS OF HG-I POLICY COMPONENT

### **#1.     *Adoption of Housing Policy Statement***

A suitable statement of housing policy was adopted by the GOH in May 1993 and published as Resolution 1038/1993. When the new government came in May 1994, it pursued policies consistent with Resolution 1038/1993. In August 1995, however, the GOH set up a new housing policy advisory body, called the Housing Policy Council, and charged this body with formulating a new set of housing policy guidelines. As of this time, the new Housing Policy Concept is as drafted primarily by the Ministry of Finance and is going for review by the rest of the government.

The draft Concept has been reviewed and found to be even more focused on the goals of the HG than was the previous statement. In particular, there is heightened concern with establishing the ability of borrowers to effectively offer their houses as collateral. It is perceived that undue difficulty of foreclosure and eviction ultimately denies citizens the ability to conclude a contract with a lender that is advantageous to both parties.

### **#2.     *Implementation of the DPM***

The Deferred Payment Mortgage (DPM) was implemented as a major option for borrowers through OTP in March 1994, shortly after the deep repayment subsidies previously offered by the GOH were ended. At that time OTP chose to portray the DPM as a special option that might be offered to borrowers who OTP branch staff felt were capable of understanding it and meeting the rising (nominal) repayments. Given the suspicions and strongly negative attitudes of the staff, it is relatively surprising that 800 DPM loans were eventually made in 1994. This was only 2 percent of all loans made by OTP for the purchase or construction of a house, but 8 percent of the loans for new houses and 11 percent of the total volume of lending for new houses.

This pattern of usage for new houses reflects several peculiar attributes of the situation. There were two special reasons why the DPM is especially preferable for new housing. First, there remains a relatively small interest rate subsidy available to buyers of new houses, such that a certain percent of the outstanding balance is paid off by the government each year for the first fifteen years. The value of this subsidy is larger if the balance on the loan is larger, as it is under the DPM.

Second, there remained the possibility of a young couple buying a new house, and expecting to have an additional child, to have their loan paid down by the GOH at the time the additional child is born. Until November 1994, this additional amount was only HUF 250,000 for the second child and HUF 600,000 for the third child, but interest on this amount from the time of the loan until the arrival of the child was also paid. Since it was likely that the balance on a non-DPM loan would be less than this amount (plus the accumulated interest), a DPM loan was preferable in these cases. The average size of a DPM on a new house started off much larger because the initial payment rate on the OTP version, 10 percent, was nearly two-thirds lower than the rate on the regular VRM (28 percent).

Two things happened in 1995 to change this situation somewhat. First, an extensive effort was made to change the attitudes of OTP branch staff towards the DPM. Second, the child-related subsidy was raised substantially, making the use of a DPM mandatory for a couple expecting to receive this subsidy at the birth of a child in the future.

The result was a 440 percent increase in 1995 in the use of DPMs by purchasers of new homes, rising to one-third of all loans made for new houses. Notably, the average size of a DPM for a new house was twice the amount of the average standard variable rate mortgage. The use of DPMs for existing homes also rose somewhat, by 87 percent, reflecting an increase in the acceptance of the concept. However, the DPM was used by less than one out a hundred buyers of an existing home (partly because several adverse underwriting standards employed by OTP keeps

the advantage in terms of loan amount to less than 50 percent more). In total, DPMs constituted about 23 percent of the volume of OTP's lending for home purchases in 1995.

### **#3. Reforming GOH Housing Finance Subsidies**

There have been dramatic changes since 1993 with respect to GOH housing subsidy policy. As required under the HG agreement, mortgage subsidies were drastically reduced as of the beginning of 1994; loans for existing homes and most rehabilitation lost all subsidy and the subsidy for new houses was halved. The child-related lump-sum subsidy remained available for new housing. Meanwhile, the previous exclusion of housing from the 25 percent Value Added Tax was partially removed in early 1993 and then fully removed as of December 1994.

At the time of the termination of any exclusion of new houses from the VAT, the GOH attempted to recycle the funds raised from the VAT on housing into an expanded child-related lump-sum subsidy for new houses. The decision to focus nearly all of the subsidy on the second and third child caused these incremental subsidies to soar to HUF 1 million, a large sum relative to the cost of a house. The complex set of effects of this shift are explored in an attached report entitled **"Further Analysis of the Housing Construction Allowance."**

One of the most notable aspects of this new version of the Social Policy Allowance, renamed the Housing Construction Allowance (HCA), was that it worked as lump-sum subsidies are supposed to. The beneficiaries could clearly see the benefits and reacted accordingly; the GOH was cognizant of the full cost of the subsidy and also acted relatively swiftly. The result was that the subsidy was extremely popular but was significantly truncated in May 1995 due to its large revenue losses.

The methods of truncation are also notable. There had previously been very loose limits on the cost of a house eligible for the Social Policy Allowance (SPA) and the interest rate subsidy. To limit the use of these subsidies, these limits were cut in half for the HCA in May and are currently more likely to target these subsidies to moderate income households.

Another step in that direction was the end of the practice of giving the change over time in the nominal level of the SPA to people who were buying a new house and had previously done so and received an SPA at that time. Households were able to get any increase in the SPA (even if due to inflation) in the meantime. With the end of this practice, the HCA becomes more targeted to first-time buyers (although it remains available only to first-time buyers of new homes).

The experience with the HCA was a good illustration for the GOH of several features of counter-cyclical housing policy. First, such policies can be very expensive in total expenditures, because it is difficult to know how people will respond to a new deep subsidy. Also, it is very difficult to prevent people already in the process of building houses and others who would have built from getting the subsidy as well. Apparently, the only reason that the bulge of HUF 36 billion in housing subsidies in 1995 did not cause a fiscal crisis is because the rest of the budget ended up in much better shape than expected. However, it appears that the expense of the HCA may be another HUF 30 billion in 1996, or twice what is expected.

Secondly, such subsidies are usually very expensive relative to the amount of extra activity generated. It is now estimated that the extra cost of the HCA was about HUF 3 million per unit for the 10,000 extra units estimated to have been started in 1995, probably half of the average cost of a unit. This is also because it is difficult to focus the subsidy only on those at the margin of entering the market and not on those who would have built anyway.



The third lesson of the HCA experience is that housing subsidies can be a politically popular palliative in times of austerity. The general public takes greater interest in "gifts" being offered in this realm, relative to, say, boosts in infrastructure expenditures or even unemployment payments.

The GOH continues to consider a major new subsidy program, through support of German-style Bausparkasse. (The GOH has received critical commentary on the Bauspar approach for the last two years, including detailed comments on their proposal this year.) The proposed subsidy is for a match of up to 40 percent of qualifying savings. Such a subsidy is in principle better than some other common subsidies, including the HCA as currently designed. But the system usually requires the creation of a separate financial intermediation process that could not survive on its own. The general trend in developed countries is towards integrated, not segmented, financial systems and there seem to be enough reason for not following this approach in Hungary.

If the Bauspar approach is pursued, along with the related expansion in loan subsidies, consolation can be taken in the fact that it may engender increased interest in lending not only under the contract savings plans, but also for additional loans to complement the Bauspar loan. This situation may go far towards addressing issue #8 below, competition with OTP.

#### **#4.     *Actions to Reduce Credit Risk***

Significant actions were taken in 1993 and 1994 in this area. The Rental Act of 1993 made it relatively easy to evict tenants, including those who became tenants by virtue of being foreclosed upon. Legislation on court procedures in 1994 introduced the possibility of obtaining "notarized" mortgages which could be foreclosed upon without normal court contestation. Thus, loans originated after 1993 will be subject to a legal framework that is fairly supportive of the access of housing lenders to the housing collateral.

The overall effectiveness of the new procedures has been the subject of some recent HG-related TA. It appears that OTP has not moved aggressively to utilize its new powers. OTP seems to wish that some other entity sponsored by the government would take over the execution of defaulted mortgages. This area should continue to be monitored closely in 1996.

There is also discussion of further statutory improvements in the foreclosure process. The fact is that the process needs substantial improvements, so attention should be paid to any potential for obtaining these.

#### **#5.     *Souder Lending Practices***

This is more of a goal of the TA component than of the policy component of the HG program. However, it is worth noting that, in adapting the DPM to its perspectives, OTP did explicitly evaluate the greater risks involved in the loan and specify more conservative underwriting criteria for it. In general, OTP has proceeded with lending during the transition period cautiously, fully aware that its previous favored position for loan recovery through wage garnishment has ended. Moreover, banking regulators are now requiring proper write-offs for delinquent loans, giving OTP full incentives to employ sound underwriting and delinquency management techniques.

One area of uncertainty here is the accounting treatment of the deferred interest on the DPMs. It appears that OTP's accountants are requiring that the unpaid interest be written off fully as loss until it is paid. This is



unreasonable and makes the DPM less desirable. In anticipation of increasing interest in the DPM as the HG-lending moves forward, some TA may be useful in respect to this accounting rule.

#### **#6. Credit Enhancement Structure**

Developments in this area are on hold until there is more evidence that basic credit risk is being managed well. Since delinquency rates continue to rise at OTP, this evidence will have to be fairly substantial to permit moving ahead with the creation of any kind of risk-shifting mechanism.

#### **#7. Accessing Long-Term Funds**

No additional actions on the actual start of a secondary market of some kind are likely until either credit risks are better managed or there is a greater need for a liquidity facility to support expanding mortgage lending. However, the Ministry of Finance continues to work on legislation required for the development of mortgage-backed bonds. It seems to be desirable to have the statutes in place so that the market can proceed in this area when it is ready.

#### **#8. Encourage Competition with OTP**

This issue is very much involved in the process that will take place soon of allocating HG funds to competing lenders. It appears that up to 5 institutions will seek HG funds. Some of these funds will be for refinancing loans for infrastructure or construction. Encouraging competition in these areas is as worthwhile as in the area of housing lending. Thus, efforts will be made to allocate a portion of the funds to institutions proposing to pursue any of the qualifying lending. However, at least half of the funds must go towards financing endloans to home buyers and those loans must be DPMs (or similar). Thus, it is likely that OTP will receive the majority of the funds in this round. This could change in a second tranche.

The process of bank privatization and revitalization seems to have accelerated recently, with the purchase of controlling interests by foreigners in some cases and the sale of most of OTP to the general market. There seems to be some perception that domestic banks have a competitive disadvantage in lending to the safer commercial entities in Hungary and thus the domestic banks may be developing a greater interest in pursuing an area where they should have an advantage, consumer lending, including for housing. Greater interest in this area would be beneficial for every aspect of the housing finance market.

## **ANNEX A**

### **FURTHER ANALYSIS OF THE HUNGARIAN HOUSING CONSTRUCTION ALLOWANCE**

February, 1996

In November 1994, the Government of Hungary announced the first major counter-cyclical housing construction program since the political and economic changes in 1989. The program of Housing Construction Allowances (HCA) was an expansion of the Social Policy Allowance program, whereby purchasers or builders of new houses received a grant from the central government. A large increase in the grant, combined with certain key details as to how the program was administered, prompted a significant increase in housing construction. However, the program has proven to be far more costly than expected. For this and other reasons, the HCA program should be examined for lessons about the difficulty of counter-cyclical housing policy.

This paper is the second of an on-going analysis of the HCA program. The first analysis was completed in draft form in August 1995, and provides a more extensive discussion of the program. The focus of this paper will be on predicting the future costs of the program and how the restrictions imposed in May 1995 will modify it over time.

#### **A BRIEF OVERVIEW**

On November 24, 1994, the Government announced that the Social Policy Allowance, a lump-sum subsidy for new housing based on the number of children, would be substantially increased as an inducement for increased construction activity and that the name of the allowance would be changed to the Housing Construction Allowance (HCA). The amount for a family with two children was boosted from HUF 300,000 (USD 2,500) to HUF 1,200,000 (USD 10,000) and for a family with three children from HUF 900,000 (USD 7,500) to HUF 2,200,000 (USD 18,333).<sup>1</sup> The amounts for the first child and any children beyond three were increased, but remained relatively small.

In March 1995, the Government announced that eligibility for the subsidy was to be significantly truncated soon thereafter, as part of an emergency austerity package. Despite this shift, it appears that, between November and 2 May, Hungarians took actions that will mean the disbursement of about HUF 60 billion in HCA during 1995 and 1996. Roughly adjusting for the size of the Hungarian economy relative to the U.S. economy, this amount is the equivalent to about USD 60 billion, larger than any similar policy shift ever undertaken in the U.S.<sup>2</sup>

It is essential to put this shift in subsidy policy within the proper context. Lump-sum subsidies for the purchase or construction of a new housing unit have been a feature of Hungarian housing subsidies since 1971. The amount of the subsidy has risen significantly over time, on net much more than the overall level of consumer prices and incomes. It took its largest previous jump in 1989, from HUF 105,000 to HUF 200,000 (the equivalent of about 600,000 in 1994 HUF) for two children. At the same time, the previous tendency to favor households with two or three children became more pronounced.

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<sup>1</sup> It should be noted that these figures already had been increased at the beginning of 1994, from HUF 250,000 and HUF 600,000 respectively. Thus, in one year, the amount for 2 children had gone up 250 percent and for 3 children had jumped 367 percent.

<sup>2</sup> To put this into the perspective of U.S. policymakers, this amount is one-third of the cost of the entire bailout of the Savings and Loan industry that received worldwide attention.





The increase in the HCA for two children in 1994 placed it at a level twice as high relative to the cost of a new house as it had ever been before. In fact, the amount for three children was over half of the direct costs of constructing a new house in most areas outside Budapest. The increase for three children in November 1994 is even larger when viewed in the context of the fact that as of the end of 1993, the SPA for three children had been increased by 50 percent, from HUF 600,000 to HUF 900,000. Thus, in the space of one year, the amount for such families had gone up HUF 1.6 million.

The stated purpose was to increase the construction of houses, which had been declining steadily since 1989 to a level only one-fifth that of peak production in the 1970s. The subsidy appeared well designed to do so, since the increase was very large, its introduction attracted significant publicity and there were some public indications that the increase could be temporary, so anyone contemplating home construction in the future was encouraged to act sooner rather than later. In this sense, it was intended to be a counter-cyclical policy.<sup>3</sup>

The other important aspect of the context was the shift since 1992 towards applying the full amount of the Value Added Tax (VAT) to new housing construction. Housing had initially been exempt from the VAT, a substantial subsidy in principle since the VAT rate was 25 percent on most other consumption goods. In 1993, housing became subject to the VAT, but 60 percent of it was refundable up to a taxable base of HUF 2.64 million (i.e., a maximum of HUF 400,000). Then, on the date of introduction of the HCA, this exclusion from the VAT was removed, presumably raising the cost of most new houses by HUF 400,000.

From this perspective, the increase in the HCA was simply a compensation for the end of the VAT exclusion. In fact, there seems to have been the hope that the increase in VAT collections would largely offset the higher HCA. On the other hand, by virtue of the targeting of the increase in the lump-sum subsidy to only certain families and by simplifying the access to the subsidy, it was expected that the shift would provide some net stimulus to housing construction.

## DETAILS THAT MATTERED

At first glance, the HCA program appears to be a relatively simple and efficient counter-cyclical program. A lump-sum subsidy was offered during a limited time period for the construction or purchase of a new house. Then why has it been so expensive for a relatively small impact on housing markets (as will be shown below)?

Part of the answer is that, for general reasons discussed below, nearly all counter-cyclical housing programs turn out to be very expensive for a small net impact. The rest of the answer lies in several important details.<sup>4</sup>

One of the most important details is that many households other than those starting to build houses after November 24, 1994, were eligible for the HCA. A house started before November 24 was eligible if any claim to a

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<sup>3</sup> Sometimes any subsidy designed to stimulate new construction is considered to be counter-cyclical, in the sense of encouraging employment. The term is used here in its more technical usage, as referring to stimulating employment and economic activity specifically during an economic downturn, not just in general. A permanent incentive to build more houses will give a country more houses and less of other things, but will not reduce the highs and lows of the economic cycle.

<sup>4</sup> It is common that subsidy programs in any country operate in a manner significantly different from first appearances.



VAT refund or the Social Policy Allowance was renounced. Apparently, in the interest of not upsetting those potentially excluded, this provision was not interpreted narrowly, so that even those who had already received these subsidies but had not finished their house could return them and receive the HCA instead.<sup>5</sup> Since the typical self-built house (most new houses) takes about two years to complete, most of the houses started under construction in 1993 and 1994 could claim the HCA. However, only those households with 2 or more children would find this advantageous.

In the data on loans made by OTP in 1993, it appears that the number claiming a Social Policy Allowance for two or more children was only 30 percent of all the number buying or building a house that year. (This figure suggests that normally families with their full complement of children already own a house and are not building one.) How many houses in the process of construction were potentially retroactively eligible for the new HCA?

Based on the rate of housing completions during 1993-94, it seems that about 40,000 housing units were started during the two years. If the share being bought or started by families with 2 or more children was 30 percent (or 12,000), and 85 percent of these (or 10,000) were self built (the share for 1993 alone), then 10,000 households is an estimate of the maximum number of self-builders that would seek to switch to the new HCA from the VAT refund and old SPA.

This is consistent with the data for payments of the HCA made by OTP up through June of 1995, about HUF 13 billion for about 10,000 households. Since the payment is made at time of sale for purchased homes and between one-third and two-thirds of the way towards completion for self-built homes, all of the payments by June 1995 may have been for purchased homes (say, 1,000, half of the total sold by developers in 1995) and for self-built homes started prior to November 27, 1994 and choosing to use the HCA (say, 9,000 units). The households that started before December 31, 1994, were giving up an average VAT exemption of HUF 350,000 and a average SPA of about HUF 250,000 for an HCA of HUF 1,300,000 on average, for a net extra cost to the government of HUF 7.0 billion. These overlap houses presumably absorbed a total of HUF 13 billion of the HUF 32 billion paid out in HCA in 1995, with absolutely no effect on housing construction.

A second detail worth noting is that thousands of households took advantage of the delay of over one month between initial announcement and final effectiveness of the 2 May modifications to get a housing project grandfathered under the earlier rules. Apparently, anyone with clear title to a plot of land and some nominal architectural plans could apply for a permit to build and qualify under the old rules. Some of these eligible households, especially those with larger families, then advertised in the newspaper seeking parties interested in sponsoring their completion of a house, i.e., to receive the subsidy but then "sell" to the sponsor. Apparently, the permission to build is good for two years and thus only once all the applications for permits are in this two year pipeline will it be known how many more units could qualify under the original rules in the future.

A third important detail is that the HCA (and the SPA before it) were available to households that had already claimed an SPA before. Essentially, the difference between the nominal amount claimed before and the new amount could be claimed, reflecting either an increase in the number of children or the increase in the subsidy amount (due either to inflation or not). It was not a one-time subsidy for buying a new house.

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<sup>5</sup> This is not entirely clear. As of August 1995, the author was informed that households which had signed loan contracts embodying an SPA were not allowed to abrogate them in favor of one including the HCA. In February 1996, he was told that it was not possible to prevent this from happening. It may be possible to develop data on this through OTP, if they in fact went back to change the data for earlier months.



This fact is useful in understanding the response to the increase in the SPA, especially in the smaller towns and villages, where self-construction of houses is a routine method of obtaining a family's first house. The HCA for a family with three children was now set at HUF 2.2 million. Since the highest this amount had ever been before 1994 was HUF 600,000, nearly every one of the 180,000 households in Hungary with three or more children was now entitled to a grant of at least HUF 1.6 million towards a new house (and generally at least HUF 2.0 million). In this context, the HCA became either a ready method of moving up to a bigger house or simply a financial transaction, whereby most of the out-of-pocket costs of the house were covered and the house could then be sold. Of course, many of these types of respondents would be well-established families with higher assets and incomes than average.

One implication of this situation was that many ordinary families with fewer than two children would find it preferable to arrange for the families with 3 or more children to build the house and then buy it from them as a "used" house. This would imply possibly an actual decline in the number of smaller households buying new houses. The downside of this arrangement are the extra risks that both parties take that something could go wrong and also the extra cost of the transfer tax of 2 percent.

Another important detail along these same lines is that the allowance for an additional child can also be claimed later when the child arrives. Moreover, the maximum amount to be claimed at that future time is the initial extra amount due (i.e., HUF 1 million), plus all interest that would have been paid or accrued on that amount.<sup>6</sup> In the current environment of high interest rates, the amount eventually paid for a second or third child could easily be several million forints. However, the amount paid at the delivery of the additional child is limited to the amount outstanding on the loan.

An implication of this is that the full future value of having a child can only be realized if as large a loan as possible is taken out and the balance on the loan grows over time, preferably at the rate that the amount eventually due from the GOH is growing. The best that a household can do along these lines is to take out a Deferred Payment Mortgage, which starts off larger and accrues a portion of the interest as time goes on. It appears that about 3100 households took advantage of this in 1995 by utilizing the DPM loan from OTP for a new house, which could mean at least HUF 4-5 billion (including interest) in extra budget expenditures on the HCA in future years. Another implication of this is that households with above-average incomes are in a better position to take advantage of it because only they are able to qualify for a loan of over HUF 1 million.

## THE EFFECTS

The preliminary evidence suggests that the HCA has been successful as a counter-cyclical subsidy in certain regards. The number of permits issued for residential construction in the first three quarters of 1995 rose 93 percent from the depressed levels of the first three quarters of 1994. (The fourth quarter was the same as for the fourth quarter of 1994, a period already swollen by last-minute permits in order to become grandfathered with respect to the VAT refund.)

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<sup>6</sup> Apparently, the situation is construed as being that the family was due the full amount that they eventually qualify for at the time the house was paid for. If a loan is taken out to finance this amount, then the initial loan amount (that part to cover the "delayed" allowance), plus the interest, is due.



How many more units were started in 1995 than if there had been no change in the SPA (into the HCA) and the VAT refund still ended? That would be one measure of the boost that the economy got from this policy. Unfortunately, for a number of reasons, Hungary does not estimate the starts of new houses. However, an estimate can be constructed from the few facts known and some guesses.

One key fact known is that OTP approved payments of HCA on 26,800 units in 1995, including 1,000 units where the household was due an HCA payment because of a birth during the year, for an average of HUF 1.3 million. Another key fact is that the Ministry of Finance reimbursed OTP a total of HUF 32 billion in 1995. At an average HCA of HUF 1.3 million, that implies that about 25,000 households were beneficiaries of the HCA from OTP during the year. (The role of the savings co-ops in this process is completely unknown.) If 9,000 of those were started by self-builders before 1995 (as suggested above), then about 16,000 housing units were sold or were self-built and reached in 1995 at least the one-third completion point required to have any HCA disbursed. Those that were sold by developers, almost 2,000 in 1995, had also been started before 1995. That leaves 14,000 self-built units started in 1995, reaching one-third completion, and receiving the HCA.

Another set of starts were by those not eligible for the HCA. In the past, total housing production was twice the level of those collecting any SPA. But in 1995 it seems unlikely that many people building new houses would not qualify for some amount of HCA. A conservative estimate would be to say that in 1995 the number of houses started by those not eligible for an HCA was only half of the number normally started recently by those not eligible for the SPA (about 10,000). That implies that in addition to the 14,000 noted above, there were 5,000 started and not eligible.

A third group of houses started during the year were those started but not yet one-third complete. If it normally takes two years to finish a house (that is faster than for most self-built houses), then presumably it takes at least 6 months to reach the point of one-third completion. That implies that most of the 14,000 self-help units that are estimated to have been started and qualified in 1995 were started before July 1. It seems reasonable to expect that this pace of starts continued in the second half because of the delays in getting permits. Thus, the additional starts of self-built houses would be another 14,000.<sup>7</sup> Finally, there are those units started by developers and not yet sold, perhaps another 2,000 (the number sold by developers in 1995).

These calculations imply that a total of 35,000 houses were started in 1995. How many would have been started in the absence of the HCA? This is another figure which is hard to know, but since the market seemed to have bottomed out in 1993-94 at 21,000 completions a year, 21,000 would seem to be the minimum estimate. However, it is important to recall that construction in 1995 was going to receive a boost anyway from the surge in building permits received at the end of 1994 in order to be eligible for VAT refund. Thus, a figure of 25,000 seems reasonable and is consistent with the final figure on completions for the year of 24,721.

This analysis yields the nice round number of 10,000 as the estimate of the number of units started in 1995 because of the HCA. The cost of these extra starts in terms of extra subsidy can also be estimated. It is estimated above that an extra HUF 7.0 billion was spent on units started prior to 1995. It is also assumed that 5,000 units started

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<sup>7</sup> It is very problematic to say how the disbursement process on these houses was operating in 1995. There was a great incentive to get the HCA disbursed, given its magnitude and the high level of interest rates and inflation during the year. However, OTP had a variety of procedures to spread the HCA out of the construction process. So the assumed six-month period to full disbursement may be too short.

in 1995 did not receive the HCA (but presumably received the VAT refund). That leaves 30,000 units that did or will receive an HCA. Since the average HCA for 1995 was HUF 1.3 million, that suggests a total expenditure of HCA on units started in 1995 of about HUF 39 billion (of which HUF 19 billion has already been paid).

How much would these units have received in VAT refund and SPA? A share of these units, say, one-third, got permits before 1995 and would have qualified for a VAT refund, averaging HUF 350,000. In addition, with the higher SPA as of 1994, these units probably would have averaged almost HUF 500,000 in SPA. These observations imply that, if the VAT had ended and the HCA not enacted (but the SPA retained), the subsidy cost of these 30,000 units would have been HUF 18.5 billion anyway. Thus, the full extra cost for these extra units is estimated to be HUF 27.5 billion (39 minus 18.5 plus 7 for pre-1995 units), or about HUF 2.8 million per extra unit started in 1995.

(A similar calculation could be made for the extra cost of extra units in 1996. However, as noted below, it is very speculative to state the number of units likely to be started in 1996. It is as difficult to guess what the starts would have been with no VAT refund and the old SPA. Thus the exercise seems too unlikely to yield a believable estimate.)

## INITIAL EVALUATION

The HCA must be declared as an unmitigated success in at least one dimension. It was a transparent, lump-sum subsidy, and, as such, the full benefit was recognized by the potential beneficiaries. Of course, while the GOH knew the cost per recipient (as opposed to the former repayment subsidies), it still could not anticipate the total cost of the program until it knew the number of beneficiaries. As it was, even though it still did not know that number in March 1995, it had become clear that the budgetary effects would be larger than anticipated and the program was truncated. Moreover, since the budgetary effects were largely immediate, the program became a useful target of the general austerity program of the Government. It appears to be a textbook case in the advantages (and some disadvantages) of a up-front lump-sum subsidy.

It may be possible to assess on a preliminary basis the effectiveness of the program in other respects. It clearly boosted the production of houses in 1995, with an estimated effect of 10,000 units. The cost per extra unit of the countercyclical effect is estimated to be HUF 2.8 million. Is this high? It is less than the total cost of building additional units and giving them to local governments, especially if the local governments would have not set rents over the lifetime of the unit that at least cover operating expenses. On the other hand, it may have been of broader benefit to the Hungarian public at large (rather than a lucky few) to have expended the funds on accelerating planned investment in infrastructure. (This latter approach, however, would have prevented what appears to have been public pleasure in seeking this lottery prize). From a macro point of view, it is very likely that the Hungarian public borrowed HUF 28 billion from its total savings and added 10,000 units of housing when it could have done a large number of more useful things with these scarce savings.

Was the program successful in utilizing resources that would otherwise been idle, such as unemployed labor? No effort has been made yet to examine any data relevant to that question. The only thing that seems likely is that the impacts on employment will be spread out over two or three years.

The estimate of the cost per extra unit also illustrates the extraordinary efforts that have to be made to prevent a countercyclical housing subsidy from being spread over the normal on-going production of houses as well. The estimated cost per extra unit was twice the size of the actual average subsidy, because so many people receive it for doing what they would have done anyway. In the extreme, if a new subsidy program is received by all new housing



units and the program succeeds in boosting construction by 50 percent, the cost per extra unit will be three times the subsidy per unit.

Another relatively successful aspect of the experience was the reasonably short time for the government to react to the mounting cost (when legislation is required to set up or end a program, the lags are usually much longer). From a countercyclical point of view, it is not entirely unfortunate that there was over a month delay between announcement and effectiveness of the changes in the program, but it seems that more should have been done to limit access to the old program to those actually starting houses in the near future (not simply drawing a permit).

Another criteria for evaluating the program is that of the distribution of the benefits. The principle beneficiaries appear to have been families with 2 or more children (or one child and expecting to have a second) who happened to be already building or thinking of building a new house. Those without the children (especially young couples with no children) and those not in a position to build or buy a house almost immediately were not benefited. Across communities, those areas where people are more able to own plots of land and undertake construction themselves (e.g., the villages) were relatively advantaged.

Another relevant aspect of the experience with the HCA is that a truly valuable subsidy evokes great efforts on the part of the public to benefit from it in unintended ways. Similar experiences have been encountered in the U.S. A large subsidy in the early 1970s for the purchase of a home by poor families prompted large scale fraud or abuse on the part of renovators (because the houses had to be in good condition at time of purchase), real estate agents, and by others who had much to gain. The poor families did not have to put any money into the transaction and thus had no incentive to identify fraudulent practices. On the other hand, it is well known from past experience that small benefits will not elicit much interest from even the intended beneficiaries.

In the case of the HCA, apparently media coverage was high and people immediately began to look for ways to qualify. As noted above, many of those who had already started houses found ways to qualify. Others figured that, while they did not want to build a house for themselves, they had such a large eligibility that they should build a house supposedly for themselves and then sell it to someone else with a small eligibility. Still others are building additions that are classified as separate units by the local government, which is the only criteria that OTP applies to determine eligibility.

## **THE FUTURE**

The question of most immediate relevance is how many more housing units will receive the HCA in 1996. Moreover, since the HCA will not be ended before the end of 1996 at the earliest, the effects will also be felt well into 1997. Unfortunately, there does not seem to be any reliable way of narrowing the range of guesses to less than 100 percent.

At one extreme, it is very plausible that the state of the public's finances and their access to credit is such that production levels above the 20-25,000 unit range can not be sustained. If so, the starts of new houses will fall back towards that range in 1996, or even lower. Completions would probably rise from the 25,000 in 1995 to 30,000 in 1996. Payments of HCA would consist of the HUF 18 billion for the 14,000 units thought to be underway already and another HUF 13 billion for another 10,000 eligible units started in the first half of 1996.

This seemingly conservative estimate would imply expenditures of at least HUF 30 billion, or twice what the Ministry of Finance is currently estimating. Is this really the low end of the possible range? In principle, the limits put on the use of the HCA in May 1995, particularly the end to the practice of getting the increase for children already benefiting from an SPA, should dampen its use dramatically. However, there are two potent contrary considerations.

First, an enormous number of permits qualify for the HCA under the old rules. There were already over 50,000 valid permits outstanding as of 1994, and, between September 1994 and December 1995, another 53,000 permits were issued, all of which may qualify under the old rules. Moreover, the pace of permit issuance was the highest for the year in the last quarter. And the pace of applications approved by OTP for either the HCA alone or a loan and the HCA was only slowly drifting down from the summer highs, perhaps for seasonal reasons.

The second consideration is that experience in other countries with subsidies that have extreme "discontinuities" in them are naturally subject to more abuse. In other words, if it is worth HUF 1 million, much less HUF 2 million, to have a house cost be under the expense limitation or an addition declared a new house or to "sell" the rights to develop under the old rules, then it is much more likely that efforts will be made to bend the situation than if the subsidy were not so discontinuous, e.g., phasing out the subsidy as the house gets more expensive or the subsidy at stake is only HUF 100,000.

These two considerations suggest that many of those outstanding permits will be used and that people will over time become more ingenious at accessing the HCA until it is reduced by policy or inflation from its current stature as a Jackpot [note to translator: this means "an extremely large prize;" please use that description if the Hungarian equivalent does not exist]

These considerations also give some grounds for concern that the costs of the HCA will be even higher. It is simply impossible to say what the response pattern will be. What is much more certain is that when the effect wears off, housing starts will be significantly lower for a while. Meanwhile, it is likely that the market in existing houses will feel the drag from the competition from new houses.

Another important aspect of the future is the question of where housing subsidy policy goes from here. In principle, the nature of the HCA was changed dramatically as of 2 May 1995. The amounts of the subsidy were not changed at that time, but the program was targeted in two key ways. First, the limitations on the maximum cost of the house were cut in half. The resulting pattern of limitations appears to be more congruent with targeting towards a moderate income population who might not build a house otherwise. This feature is desirable from the viewpoint of more net redistribution of income to lower income groups and because the net effect on construction, per forint of subsidy, is probably higher.

The other change put into effect was, for the first time, to limit the allowance to those who had not already received such an allowance before for the very same children. Previously, anyone could get the increase in the SPA for, say, two children, since they last took the SPA for the same two children.

Thus, the HCA may be currently more targeted to first-time new homebuyers of relatively small houses. This is a significant move towards what appears to this observer to be the most sensible targeting of such a subsidy, i.e., households who are at the margin of being able to afford to buy a house. This latter criteria would exclude those



households with the income or assets to be able to buy more than a minimal house and certainly those households who already have achieved homeownership.<sup>8</sup>

The key remaining differences are the requirement that the house be new (which automatically limits the benefit to the relatively better off among the first-time homebuyers) and that the family have two or more children. As noted elsewhere, this latter requirement is poor social policy from most perspectives, poor population policy and poor housing policy. The use of the number of children was perhaps a major determinant of the economic circumstances of the household in the socialist economy of nearly uniform wages, but in the new market economy incomes vary far more significantly than child-rearing costs.

The GOH is considering a proposal to provide matching funding to those households receiving grants or loans from their local government. This is not as clean a targeting as a central government program for all first-time buyers of new or existing houses under a certain size, but it introduces the potential for the local government to customize the targeting according to its on-the-spot judgments of individual circumstances. Such a program is certainly superior to the revised HCA, with its remaining emphasis on children, but its introduction now, when the local governments are experiencing severe fiscal stress, may not be desirable.

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<sup>8</sup> The argument has been made that there are some households who are homeowners who are effectively as bad off as not being homeowners, e.g., those owning pre-fabricated flats that can not be sold for any reasonable amount. An exception could be carved out for those households who move to another city and whose previous flat is appraised at less than 1 million forints.